No. 15,181

In the

United States Court of Appeals

For the Ninth Circuit

JOHN P. DALEY, MINERVA B. DALEY, MORRIS DALEY, ZELMA B. DALEY, WILLIAM RADTKE, CLARA RADTKE and HOMER BOSSE, Trustee of the Estates of Morris K. Daley, Alice M. Daley, Susan R. Daley, James D. Daley, Kathryn F. Daley and Peter D. Daley,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appellants' Opening Brief

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JURISDICTION

This is an appeal from a judgment of the United States District Court for the Northern District of California, Southern Division, against the plaintiffs, taxpayers, and in favor of the defendant, United States of America.

The action brought in the District Court was for recovery of income taxes in excess of $10,000 alleged to have been erroneously and illegally assessed and collected under the 1939 Internal Revenue Code by a Collector of Internal

Revenue not in office at the time the action was commenced. Complaint, paragraph I (Tr. 3). The jurisdiction of the District Court was based upon Title 28, United States Code, Section 1346(a)(1)(ii).

The judgment of the District Court, filed and entered on March 23, 1956 (Tr. 112) was a final decision of the District Court, and the appellate jurisdiction of this court is found in Title 28, United States Code, Section 1291.

STATEMENT OF THE CASE

Plaintiffs John and Morris Daley had been engaged in the construction business since 1935, doing business in partnership as "Daley Brothers." They had consistently followed the completed contract method of accounting in connection with that business, under which profit or loss on construction contracts is determined and reported for tax purposes only when the contract is completed.

On June 30, 1942, John and Morris Daley formed a new partnership, Daley Bros., Ltd., to continue the construction business theretofore conducted by them. This partnership consisted of themselves as general partners and plaintiff Homer Bosse as trustee for their children as limited partner. On July 8, 1942, a War Department contract was obtained in the name "Daley Brothers" (but for the benefit of Daley Bros., Ltd.) for the construction of the Abraham Relocation Center at Delta, Utah. Daley Bros., Ltd. and plaintiff William Radtke formed a joint venture to perform this contract. The contract was originally scheduled for completion on September 6, 1942, but the time for completion was extended several times and the contract was finally completed and accepted by the United States on February 16, 1943.

In January, 1943, when the Delta contract was 99% complete, an army officer assigned to renegotiate the Delta con-

tract required that the books be closed on that contract as of December 31, 1942, so that the contract could be renegotiated for 1942 and he could "get off to war". John Daley, who was the managing partner, protested closing the books on the Delta contract before it was fully completed, but finally agreed to do so. At the time the Delta contract was obtained, the full contract price was entered in the books of account as an account receivable without regard to the time at which the right to such price would accrue. Upon closing such books on December 31, 1942, there was deducted from such full contract price costs which had been incurred to December 31, 1942 in performing such contract, plus some additional costs which the accountant estimated would be incurred to complete the contract. Thus the books of account after closing as of December 31, 1942 showed the profit estimated to be realized upon completion of the Delta contract, and the contract was renegotiated on that basis.

The joint venture filed a separate partnership income tax return in the name "Daley Brothers Delta Venture" for 1942 with respect to the Delta contract, and reported income from the Delta contract in accordance with the books of account. In so doing, they reported the *full contract price* of the Delta contract as gross receipts for 1942, even though the joint venture had not received, and was not then entitled to receive, $472,722.15 of that price. This sum represented "holdbacks" which the United States was entitled to retain until final acceptance of the contract, and the price of certain items of the contract which had not then been approved for payment by the contracting officer. Such items are income only when the conditions relating thereto have been removed. See, e.g., *Chas. F. Dally v. Comm'r.* (1953). 20 T.C. 894, aff'd (9th Cir. 1955) 227 F.2d 724, cert. den., 315

U.S. 908. No partnership return was filed by Daley Brothers Delta Venture for 1943, because all the income from the Delta contract had been reported in 1942.

When the plaintiffs discovered the error which had been made in the 1942 Daley Brothers Delta Venture return, they filed timely claims for refund, based on amended returns. The amended return for 1942 corrected the original return by eliminating from gross receipts the $472,722.15 which was improperly accrued, and by showing the balance of the contract price as gross receipts which had been paid as "advances." The amended 1943 return reported the full amount of the income from the Delta contract in that year when the contract was completed. The changes in tax liability thus computed resulted in net overpayments of taxes for the two years 1942 and 1943 taken together, and refunds for such overpayments were requested. The claims for refund were denied and the plaintiffs brought the action in the District Court below.

In the District Court the plaintiffs presented evidence which proved, to the satisfaction of the District Court, that the 1942 return was erroneous in reporting the full contract price of the Delta contract in that year because the joint venture had not received and was not entitled to receive $472,722.15 of that price until after the close of the year.

The plaintiffs also presented evidence to prove that none of the gross receipts reported in 1942 should have been reported as income for that year because they had adopted the "completed contract" method of reporting the income from the Delta contract. The plaintiffs also argued in the District Court that whether or not the joint venture had adopted the completed contract method of accounting, it was entitled to eliminate all receipts and deductions in 1942, and report such items in 1943, because the joint venture was

required and entitled to use the method of accounting consistently used by Daley Brothers since 1935 and because no other method would clearly reflect the income from the Delta contract.

It was the position of the defendant in the District Court that the partnership had adopted the accrual method of accounting and that the 1942 return correctly reported all income which had accrued in 1942.

The District Court found that the joint venture had been entitled to elect and had elected to report its income from the Delta contract on the accrual method of accounting. The court also found that the 1942 partnership return was erroneous in reporting the full contract price as gross receipts, because a portion of that price had not accrued until 1943. Despite the error which the District Court found the plaintiffs had made in the 1942 return, the court gave judgment for the defendant. It held that the plaintiffs could not shift the Delta contract receipts to 1943 to the extent of the erroneous accrual in 1942, because the refund claims and the complaint sought refunds solely on the grounds that *all* of the receipts had been erroneously included in 1942.

The questions on appeal are whether the District Court was correct in determining that the plaintiffs had elected the accrual method of accounting in the original 1942 return, and whether in any event they are entitled to correct the admitted error which was made in the 1942 return, regardless of the nature of that error.

SPECIFICATION OF ERRORS

It is submitted that the District Court erred in three respects. Such errors are all found in paragraph III of the District Court's Conclusions of Law (Tr. 111). The errors are as follows:

1. The District Court erred in finding that Daley Brothers Delta Venture elected to report the income from the Delta contract for the year 1942 on the accrual basis of accounting.

2. Assuming that the District Court correctly concluded, as a matter of law, that Daley Brothers Delta Venture elected to report its income from the Delta contract on the accrual basis of accounting, the District Court erred in failing to allow the plaintiffs to correct the admitted error in the return filed for 1942 by reporting all of the income and deductions applicable to such contract in 1943, when the contract was completed.

3. The District Court erred in finding that the grounds stated in the refund claims and complaint for refund were *solely* that all of the receipts from the Delta contract had been erroneously reported as income in 1942.

ARGUMENT

1. Daley Brothers Delta Venture did not elect the accrual method of accounting for 1942. They either elected the completed contract method or no acceptable method at all. For this reason they are entitled to correct the admitted error in the 1942 return by reporting all receipts and disbursements in 1943, when the contract was completed.

The Internal Revenue Code[1] establishes the general rule for income tax accounting as follows:

"Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keep-

1. Citations to the Internal Revenue Code are to the 1939 Code as in effect in 1942 and 1943. Citations to regulations are to Treasury Regulations 103 (Title 26, Code of Federal Regulations) as in effect in 1942 and 1943.

ing the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income * * *."

Section 41 thus establishes as a rule of statutory law, that if the taxpayer employs a method of accounting which clearly reflects income, he must compute his income for tax purposes on the basis of that method. The Regulations reiterate this rule in the following language:

> "The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return." Regs. Sec. 19.41-2 (second paragraph).

Because the statute itself refers to the taxpayer's books of account, evidence as to the manner in which those books are kept is all important in a case of this sort. It is submitted that the District Court disregarded the direct evidence as to the ultimate accounting facts in this case, and relied instead upon evidence having no real significance in the determination of what method of accounting had been employed in keeping the books with respect to the Delta contract.

In order to understand the significance of the accounting evidence in this case it may be helpful to review the nature of the cash, accrual, and completed contract methods of accounting.

As a general proposition there are two basic methods of accounting used by taxpayers, and generally accepted as

clearly reflecting income. One is the cash method and the other is the accrual method. Under the cash method, income is reported when received and expenses are recorded when paid. Under the accrual method, income is recorded when accrued and expenses are recorded when incurred. The Supreme Court described the difference between the cash and accrual method of accounting in *Spring City Foundry Company v. Comm'r.* (1934), 292 U.S. 182, 183, 54 S.Ct. 644, as follows:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."

While the cash and accrual accounting methods are basic, the accounting profession, the Treasury Department's regulations, and the cases have recognized that there may be refinements and variations of these basic methods and that these basic methods may be utilized together with other accounting concepts, to make the computation of net income more convenient or the results of such computation more informative. If such variations are consistently applied by the taxpayer and clearly reflect the income, they are also acceptable for income tax purposes. One such refinement which has been held acceptable is the completed contract method of accounting. See *Bent v. Comm'r.*, 56 F.2d 99 (9th Cir., 1932). The relation between the accrual method of accounting and the completed contract method is not at all complex, and has been clearly and concisely stated by the Board of Tax Appeals in *Fort Pitt Bridge Works v. Comm'r.*, 24 BTA 626, at 641, aff'd 92 F.2d 825 (3rd Cir., 1937), as follows:

> "The accounting system employed by the petitioner is the completed-contract system. It is a modification of a strict accrual method and differs in the one respect that items of income and expense, though recorded in primary accounts when accrued or incurred, are not carried into profit and loss as earnings of the business until the contract to which they relate is completed. A separate account is kept for each contract. Any debit balance in the account represents the investment in the contract and any credit balance represents the unearned income until the completion of the contract. A characteristic of this system is that income earned in one accounting period may not be accounted for until a later period. It is peculiarly adapted to a business fulfilling contracts which lap over accounting periods where the ultimate gain or loss can not be accurately determined until the completion of the contract. It may be used even though the contracts call for payment on the basis of a certain price per pound. The contracts need not run for more than a year. The Commissioner's regulations permit its use. It has been approved, for tax purposes, by the courts and by this Board."

It is undoubtedly true, as stated in the *Fort Pitt Bridge* case, that the accrual basis of keeping the primary accounts is generally employed in conjunction with the completed contract method. However, the accrual method of keeping accounts is by no means necessary to the completed contract method of recording profit. Thus, in *Alfred H. Badgley v. Comm'r.* (1931), 21 BTA 1055 at 1058, the court said:

> "It is entirely clear from the books, however, that the petitioner's accounting practice was formulated with the objective of postponing an accounting of the gain or loss on each project until the project has been completed. We have not found in the 'income account' or the profit and loss account a single entry intended to

record a gain or loss on any project prior to completion. Considering the objective of the petitioner's accounting practice, the method of keeping the primary accounts was not important. They could be kept on either a cash receipts and disbursements basis, or on an accrual basis, or on a hybrid basis, without creating any impediment in attaining the objective, since the entries in those accounts were used to ascertain gains and losses on the projects to which they related only when the projects had been completed. It did not matter whether costs were recorded in the primary accounts when paid or when incurred, or income recorded when received or when due, provided that there was a complete and accurate accounting for all costs and income pertaining to each project at some time before the project accounts were closed into 'income account.' The method of accounting is not determinable alone from the practice followed in recording financial items in the primary accounts, but is reflected rather by the system in which these primary entries were carried forward to ascertain periodical gains and losses."

Obviously, if profits are to be determined only when a job is completed, the principal function of the primary accounts will be fulfilled if income earned and costs incurred at the time of completion have been recorded at that time. With a fixed-price contract such as the Delta contract, for example, the total amount of the receipts ultimately to be realized is known when the contract is entered into. It is only the costs which will not be known until completion. Since the income will not be written into profit and loss until the job is done and all costs have been incurred, no distortion will result from entering the full contract price on the books at the time the contract is signed. Since no interim determination of profit and loss is contemplated, no advantage is to be derived from making separate entries as the right accrues, from time to time, to receive portions of the total payment.

The accounting evidence in this case revealed that this was what was done in connection with the Delta contract. No entries were made when a right to receive a specific payment accrued. Instead, on August 1, 1942, shortly after the contract was obtained, *the original contract price was entered as an account receivable,* and was distributed through credit items to overhead, job costs, and estimated profit (Tr. 223-224). Similar procedures were adopted upon receiving information concerning change orders increasing the total contract price (Tr. 225). This had the effect of bringing into gross income the full amount of the contract price before any work on the contract had commenced. When the books of account were closed out to profit and loss as of December 31, 1942, no adjustment was made to the income items to reflect that the plaintiffs were not yet entitled to receive a very substantial portion of the contract price. The debit balance in the job cost account (representing the difference between the portion of the full contract price credited to job costs and job costs incurred to December 31, 1942), was transferred to profit and loss and similar entries were made with respect to the other accounts to which the balance of the original contract price had been credited (Tr. 233).

This evidence demonstrates at once why the accounting method employed by the joint venture was not the accrual method, and why the 1942 return overstated gross receipts in the amount of $472,722.15. If the accounting method adopted had been the accrual method, either the contract price would have been entered only as the joint venture became entitled to receive portions thereof from time to time, or else some adjustment would have been made as of December 31 to eliminate the $472,722.15 which had not accrued as of that date. This amount consisted of $299,-

430.73 not yet approved for payment by the contracting officer under Article 16(a) of the Delta contract (Tr. 45), and $173,291.42 retained by the United States as a "hold-back" under Article 16(b) of the Delta contract (Tr. 45). See Exhibit 15 to Stipulation of Facts (Tr. 79) from which these amounts are determined. See also *Dally v. Comm'r.* (1953), 20 T.C. 894, aff'd (9th Cir., 1955), 227 F.2d 724, cert. den., 315 U.S. 908; *U. S. v. Harmon* (10th Cir., 1953), 205 F.2d 919; and *L. O. Layton v. Comm'r.* (1952), 11 T.C.M. 1115, holding that such amounts do not constitute proper accruals until the contractor becomes entitled to receive them.

This evidence also demonstrates that the accounting method employed was the completed contract method. Taking the full contract price into income at the time the contract is entered into is a sensible procedure *only* if the taxpayer waits until the contract is fully completed before closing out the books. In addition, however, the testimony of the accountant was that he made an effort to bring into the computation of income in 1942 other costs which he considered were applicable to the contract even though not technically incurred (Tr. 220-221, 239). This makes sense only if an attempt is being made to determine the whole profit from the contract, which is the essence of the completed contract method.

Other evidence that the completed contract method of accounting was employed included:

a) The testimony of the accountant who closed the books and prepared the return that the completed contract method was used (Tr. 217, 239).

b) The stipulation of fact that the completed contract method had consistently been employed by Daley Brothers for many years prior to 1942 (Tr. 18), and

the testimony that jobs commenced in 1941 were closed out on the completed contract basis in 1942 (Tr. 175-178) and that no new books of account were established for the various joint ventures with William Radtke (Tr. 152, 218).

c) The testimony of John P. Daley that no return was filed in the name Daley Brothers Delta Venture for 1943 because the 1942 return showed the Delta contract as completed (Tr. 147-148).

It is quite clear from a reading of the opinion and findings of fact of the District Court, that its determination that the joint venture "elected" the accrual method of accounting is based upon three facts, none of which is disputed. These facts are as follows:

1. On the partnership return for Daley Brothers Delta Venture, the statement appears that it was prepared on the accrual basis (Findings of Fact V, Tr. 109).

2. In connection with renegotiation proceedings on the Delta contract, John P. Daley reported that the accrual basis was used for income tax purposes (*Ibid.*).

3. All parties knew that the contract was not completed on December 31, 1942 (Findings of Fact VII, Tr. 110).

It is submitted that the first point is wholly immaterial. The statement in the original tax return is in the Transcript at page 87. It appears under the heading "QUESTIONS" and reads as follows:

> "4. Check whether this return was prepared on the cash [ ] or accrual [x] basis."

No space appears in the return for the completed contract method. The primary accounts were obviously not kept on

the cash basis and were more nearly accrual than anything else. Perhaps of even greater significance is that question No. 4 on the amended return for 1943, which was admittedly prepared on the completed contract method, was answered in precisely the same manner. See Tr. 92. In any event, with respect to an almost identical question the Supreme Court said the following (*Aluminum Castings Co. v. Routzahn* (1930), 282 U.S. 92, 51 S.Ct. 11 at p. 14):

> "Petitioner, relying on the declarations in its returns that they were made on the basis of actual receipts and disbursements, contends that for that reason they must be deemed made under section 12(a) and not under section 13(d). But whether a return is made on the accrual basis, or on that of actual receipts and disbursements, is not determined by the label which the taxpayer chooses to place upon it."

The second point upon which the District Court relied in finding that the joint venture elected to report income on the accrual basis of accounting is based upon a statement appearing on a form submitted by Daley Brothers to a renegotiation officer on January 26, 1943. On this form John Daley replied that revenue was reported on the accrual basis, rather than the completed contract or cash receipts basis, for income tax purposes (See Exhibit 16 to Stipulation of Facts, Tr. 82).

Mr. Daley's testimony in connection with this statement appears on pages 185-189 of the Transcript, and may be summarized as follows:

> In January, 1943, the officer assigned to renegotiate the Delta contract and other contracts undertaken by Daley Brothers in 1942 was anxious to "get off and go to war". He demanded that the books be closed on the Delta contract as of December 31, 1942. John Daley believed that the information submitted for income tax

purposes had to comply with the information submitted for renegotiation purposes. Since he knew that the contract was not completed on December 31, 1942, he thought it would be necessary to report income for tax purposes on some basis other than the completed contract method. However, he did not know either then or at the time of the trial what the "accrual" basis of accounting is, and marked that space on the form only to avoid marking "completed contract."

This testimony takes on added significance in light of the renegotiation laws and procedures then in effect.[2] Under renegotiation procedures contracts were renegotiated on a fiscal year basis.[3] Moreover, if a contractor used the completed contract method of accounting for income tax purposes, the same method of accounting was required for renegotiation purposes, and such contracts would be renegotiated only after the end of the fiscal year in which they were reported as having been completed.[4] It seems clear, therefore, that unless a tax return reporting income from the Delta contract was filed for 1942, either on the completed contract basis or on some other basis, the renegotiation officer would have had to wait for a full year to renegotiate the Delta contract.

It is submitted that this evidence does not support the conclusion of the District Court that the accrual method of accounting was used in connection with the Delta contract. Mr. Daley's statement, in view of his limited knowledge of

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2. Statutes, regulations and other material appear in the Appendix.

3. Section 403(c)(5), Sixth Supplemental National Defense Appropriations Act, 1942, as amended; Renegotiation Regulations § 301.2. (Appendix pg. 1, 3.) See also "Renegotiation Procedures". (Appendix pg. 2.)

4. Renegotiation Regulations §§ 301.3, 301.6. (Appendix pg. 4, 6.)

accounting methods, meant only that results of the Delta contract would be reported for tax purposes before it was completed.

Moreover, the renegotiation officer did not require that the taxpayers shift to an accrual method of accounting. On the contrary, if adjustment had been made to report only Delta contract receipts which had accrued,[5] $472,722.15 of the contract price would have been excluded, and a loss would have resulted. This clearly would have been unacceptable to the renegotiation officer. On the other hand, if the completed contract method were applied, and the contract were considered to be complete on December 31, 1942, the renegotiation officer would get substantially the figures and result he was looking for. It is submitted that this is the sum and substance of what was done.

The third point upon which the District Court relied to find that the accrual basis of accounting was "elected", and the only point mentioned in the opinion, was that all parties knew that the contract was not completed on December 31, 1942. Findings of Fact VII, Tr. 110. Opinion, Tr. 105, 106. This, of course, does not bear upon the question of whether the accrual basis of accounting was used. It does not even prove that the completed contract method of accounting was *not* used. The District Court said in its opinion that the "fundamental feature" of the completed contract method is the practice of treating receipts as income "as of a particular time; namely, the completion date of the contract" (Tr. 105). The court also said that there was no merit to the contention that the intention was to report the receipts from the Delta contract by the completed contract method in the 1942 return "inasmuch as the fundamental aspect of the

5. As would have been required under Renegotiation Regulations § 301.2(2). (Appendix pg. 3.)

completed contract method of accounting is to report contract receipts as income in the year the contract is completed" (Tr. 106). But the District Court overlooked the fact that *it took more than 10 years of litigation* to establish what is now described as the "fundamental feature" of the completed contract method. For it was not until the decision of this court in 1954, in *E. E. Black Ltd. v. Alsup* (9th Cir., 1954), 211 F.2d 879, that it was determined that the income from a contract could not be reported under the completed contract method when the contract was substantially completed, rather than when it was fully completed. This court in that case reversed the District Court which had found that substantial completion was sufficient, and overruled a similar decision of the Tax Court in *Ehret-Day v. Comm'r.* (1943), 2 T.C. 25. The Delta contract was, of course, very nearly completed on December 31, 1942. Exhibit 15 to the Stipulation of Facts (Tr. 79) shows that on December 1, 1942 the contract was estimated to be more than 90% complete. And in the data submitted to the renegotiation officer under date of January 26, 1943 the contract is shown to have been 99% complete (Tr. 81).

Thus, the "fundamental feature" of the completed contract method is not closing out the books as of a given date (though that is one feature). The fundamental feature is reporting all receipts and expenses of the contract in one accounting period, so as to give a true picture of the results of the contract. *Bent v. Comm'r.* (9th Cir., 1932), 56 F.2d 99; *Fort Pitt Bridge Works v. Comm'r.*, 24 BTA 626, aff'd (3rd Cir., 1937) 92 F.2d 825; *Alfred H. Badgley v. Comm'r.* (1931), 21 BTA 1055. The accounting procedures adopted herein contained this fundamental and distinctive feature of the completed contract method of accounting. The error which was made was in closing out the contract before it was completed and all income earned.

It is submitted that under Section 41 of the Internal Revenue Code, the question in this case is what method of accounting was employed by the joint venture. The District Court, in finding that the accrual method of accounting had been "elected" relied only upon the fact that the contract was not completed (which establishes only that the completed contract method was not *correctly* employed), and upon the label placed upon the method by one of the plaintiffs, who did not even know the meaning of the label. As stated by the United States Supreme Court, "whether a return is made on the accrual basis * * *, is not determined by the label which the taxpayer chooses to place upon it." *Aluminum Castings Co. v. Routzahn* (1930), 282 U.S. 92, 51 S. Ct. 11 at p. 14. See also, *Pfeiffer v. Jones* (D.C. 1954), 57 F. Supp. 621; *Bancroft v. U. S.* (Ct. Cls., 1943), 49 F. Supp. 476.

There can be no doubt that if the District Court was in error in holding that the accrual method was employed, it should have permitted refunds based upon the completed contract method. If, as is submitted, the evidence proved that the appellants adopted the completed contract method, then the error which was made was to report the income and disbursements before completion. *E. E. Black, Ltd. v. Alsup* (9th Cir., 1954), 211 F.2d 879. The manner in which the taxpayer is entitled to correct the error in such cases is to eliminate all income and disbursement from the 1942 return and transfer them to 1943. See *Russell G. Finn, et al.* (1931), 22 BTA 799, at 803, where the Board said:

> "The partnership having kept its books upon the completed contract basis, the statute requires that its net income shall be computed upon the same basis. On this basis, gains and losses derived from long-term contracts are to be included in income only when the jobs are completed. Since the Northville and Oakland Hills jobs were not completed until 1921, any gains in

respect of those jobs should be eliminated from the income for 1920."

See also *Ohio Brass Co. v. Comm'r.* (1929), 17 BTA 1199, and *Evergreen Cemetery Association v. Comm'r.* (1932), 25 BTA 544.

And if the manner of keeping the accounts in connection with the Delta contract was *not* the completed contract method, it was a method which was unacceptable, since it did not "clearly reflect the income".

The cases are clear that a minimum standard for computing income established by Section 41 of the Internal Revenue Code is that there must be "income" in the tax sense in the taxable year before the taxpayer may be required or permitted to account for that income in that year. *Weiss v. Weiner,* 279 U.S. 333, 335, 49 S. Ct. 337 (1929); *Old Colony Ry. Co. v. Comm'r.,* 284 U.S. 552, 52 S. Ct. 211 (1932); *B. F. Goodrich Co. v. Comm'r.,* 1 T.C. 1098 (1943); *Evergreen Cemetery Association v. Comm'r.,* 25 BTA 544 (1932); *Ohio Brass Co. v. Comm'r.,* 17 BTA 1199 (1929); *Troy Mfg. Co.,* 7 BTA 119 (1927); Regs. Sec. 19.41-2[6]; Regs. Sec. 19.41-3[7].

And when the method of accounting adopted by the taxpayer has the effect of reporting income not earned, as was the necessary effect of the procedures adopted here, the taxpayer is entitled to adopt a different method which does not have that objectionable feature. For exampe, in *Chatham & Phenix National Bank* (1925), 1 BTA 460, a Bank for

6. "* * * The *true income,* computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return * * *" (Italics added.)

7. "* * * Each taxpayer is required by law to make a return of his true income * * *"

many years included in its income for income tax purposes discounts neither received nor accrued within the year. In 1918, the Bank changed its method of accounting for discounts to the accrual basis. The Commissioner refused to allow the change of accounting method. The Board disapproved the action of the Commissioner, stating:

> "The statute contemplates an accounting method which will correctly reflect income, and we do not doubt the reasonableness of the above regulation [requiring the Commissioner's consent to change an accounting method] when the change is from a method of accounting which reflects income to another approved method, and the Commissioner may be justified in refusing to permit a change without adjustment of prior returns. Here we have a change from a method of accounting which includes items not properly income and we do not think a change to a method which will clearly reflect income can be prevented, and the taxpayer compelled to report amounts not properly taxable as income. Whenever the bar of the statute of limitations does not prevent such action, the prior returns should be adjusted so as to show the correct income. The statute appears to have barred any adjustments herein in prior returns, but the situation is a practical one and we think the taxpayer must be permitted to place its books upon a basis which clearly reflects its income. It has adopted the accrual method for this purpose and we believe that method will accomplish the desired result when properly applied."

In *Wetherbee Electric Co. v. Jones* (W.D. Okla. 1947), 73 F. Supp. 765, appeal dismissed (10th Cir., 1947), it was held that a taxpayer, without the Commissioner's consent, could make corrections in its original returns necessary to clearly reflect income. See also *Continental Bank and Trust Co. v. U.S.* (1932), 19 F. Supp. 15; *United Profit-Sharing Corporation v. United States,* 66 Court of Claims 171.

2. Even if the method of accounting employed in connection with the Delta contract was the accrual method, the District Court should have allowed the refund based on the completed contract method because:

a) The completed contract method is the only method which clearly reflects the income from the Delta contract; and

b) Any election to report on the accrual basis was an innocent mistake of which the taxpayer should be relieved.

a) THE ACCRUAL METHOD WOULD NOT CLEARLY REFLECT INCOME IN THIS CASE.

In holding that the taxpayers had "elected" the accrual basis of reporting income *and that they were bound by that method,* the District Court disregarded a number of cases holding that an election to adopt a generally acceptable method of accounting which does not clearly reflect income in the particular case is no election at all, and the taxpayer is not bound by that "election" and may correct his error by adopting another method of accounting which does clearly reflect the income.

The doctrine of "election" denies the taxpayer the right to a refund of taxes paid only when his original return correctly reported his income. The doctrine has been clearly stated and consistently applied in a number of cases. Thus, in *Lebolt & Co. v. U. S.* (1929), 67 Court of Claims 422, the taxpayer had for five years followed the practice of adding amounts paid for customs duties to the cost of imports. Thereafter, the taxpayer filed claims for refund for each of the years on the ground that the custom duties were currently deductible. When the claims were denied, the taxpayer sued for refund. The court described the doctrine of election as follows:

> "The weight of authority is to the effect that where there are two methods of making an income tax return, either one of which is legal and proper, and the taxpayer has made his return in accordance with one of these methods, then, if the return is accepted and taxes

> paid accordingly, the taxpayer can not subsequently change to the other method of making a return and thereby become entitled to a refund. But if there is only one legal and proper method of making a return and the taxpayer erroneously makes his return by some other method, then, even though the return has been accepted and the taxes paid, he may file an amended return correcting the error, and if this return shows an overpayment, he becomes entitled to a refund."

It was held that the regulations properly permitted either treatment of customs duties and that the method originally adopted by the plaintiff was in accordance with good accounting practice. Accordingly, the plaintiff's petition was dismissed.

On the other hand, where the original basis for determining the income reported on the return was improper, the taxpayers have consistently been permitted to correct the error by amended return or claim for refund. Thus, in *Tide Water Oil Co. v. Comm'r.*, 29 BTA 1208, the petitioner had claimed to be "affiliated" with a related corporation (Tidal) and had filed its return on that basis. After the statute of limitations had run it was determined that the related corporation was not an affiliate and at that time it was too late for the Commissioner to make an assessment against the related corporation. In order to prevent the escape of the related corporation's income from taxation, the Commissioner argued both that the petitioner was estopped by its earlier representations, and that it was bound by its election to treat the related corporation as an affiliate. The court held that the petitioner was not estopped because all the facts were known to the Commissioner, and answered the arguments as to election in the following language (at page 1222):

"Election and waiver have been suggested as a basis for estopping the petitioner. In order to be bound by his election a party must have had a right to elect and must have made an election with knowledge of his rights upon which the other party properly relied. The necessary right to elect, the election, and reliance are all absent in this case. This petitioner had no right to elect whether it would be taxed by including Tidal in the affiliated group with it, or whether it would be taxed by excluding Tidal from the affiliated group. The taxing statute gave no such election, but provided that only in certain circumstances could there be affiliation. Under that statute the petitioner and Tidal were not affiliated and no inconsistent choice of theirs would have bound either the Commissioner or the taxpayers. Cases in which taxpayers had an election, made their choice and were held to it are not in point."

Another case in which the taxpayer was allowed to recover a tax erroneously paid because the method of determining income which was first "elected" was improper is *Continental Bank and Trust Co. v. U. S.,* 19 F. Supp. 15 (D.C., 1937). In that case the plaintiff had reported the full sales price from stock rights as income in accordance with an option granted by the regulations. The court held that the regulations were invalid, and since the income which had been reported was not earned, the taxpayer could correct the error and was entitled to recover the tax paid through claim for refund.

It cannot be disputed that in this case the accounting procedures adopted by the joint venture did not clearly reflect the income which had been earned from the Delta contract in 1942. There was a total of $472,722.15 of gross receipts which was erroneously included in the tax return in the year 1942. *Dally v. Comm'r.* (1953), 20 T.C. 894, aff'd. (9th Cir., 1955), 227 F.2d 724, cert. den., 315 U.S. 908; *U. S. v. Har-*

mon (10th Cir., 1953), 205 F.2d 919; *L. O. Layton v. Comm'r.* (1952), 11 T.C.M. 1115; *National Contracting Co. v. Comm'r.* (1938), 37 BTA 689 at 702.

The District Court conceded this much, but the Court held that the only way in which the error could be corrected was to correctly apply the accrual basis of accounting. The weakness in this argument is that the correct application of the accrual basis of accounting would not "clearly reflect the income." Thus, the net income reported in the original 1942 return (Tr. 86), was $206,250.44. If the improper accruals were eliminated from gross receipts, there would be a *loss* reported of $266,471.71! And when the receipts removed from 1942 were added to 1943, there would be net income in 1943 of $472,722.15. While these figures would be adjusted somewhat by moving improper accruals of deductions from 1942 to 1943, it is clear that the effect of the use of the accrual method of reporting income from the Delta contract would be to provide a large and fictitious loss in 1942 and an even larger and equally fictitious income in 1943.

There are many cases which hold that what might generally be an acceptable accounting method may in particular cases be unacceptable because not clearly reflecting income.

For example, in *Key Largo Shores Properties, Inc. v. Comm'r.*, 21 BTA, 1008 (1930) the petitioner had filed its income tax return for the year 1925 reporting the income from the sale of Florida real estate according to the installment method. The installment method was recognized both by statute and regulations. Under this method petitioner reported in 1925 a portion of the profit hoped to be earned. Before the tax return was filed, the taxpayer knew that no profit would result from the sale and that its mortgage was worthless. Without any examination whatever into the motives of the taxpayer for filing the original return on the

installment basis, the Board permitted the taxpayer to reverse its ground and report a loss. The Board explained the reasoning behind its decision in the following language:

> "Under the Revenue Acts various methods of reporting income may be adopted by taxpayers, but all are designed to correctly reflect the true income in order that a just tax may be levied and collected. If a method used by a taxpayer does not clearly reflect income, the respondent may determine the income according to a method which in his opinion does clearly reflect it. Section 212, Revenue Act of 1926. This in itself is sufficient to demonstrate that it was not intended that taxpayers should be irrevocably bound by the election of a method of reporting when that method is erroneous. The effect in this case of requiring adherence to the basis originally adopted by the taxpayer would be to set up and tax, as income, an amount which in fact is not income. Neither administrative rules nor the forceful arguments in favor of administrative expediency can create income where in fact there is none, and, after all, it is only income that is to be taxed. In our opinion the installment basis when applied to the facts in the present case does not reflect the taxpayer's income."

The facts and results were similar in *Ives Dairy, Inc.* (1931), 23 BTA 579, aff'd (5th Cir., 1933), 85 F.2d 135. Normally, of course, the election of the installment method of reporting income is binding on the taxpayer. See *Pacific National Co. v. Welch* (1937), 304 U.S. 191, 58 S. Ct. 857, but also note that in this case the Supreme Court carefully pointed out that there was nothing indicating that the method originally chosen "rightly applied, * * * would not clearly reflect income." (at p. 858)

Similarly, in *Reynolds Cattle Co.* (1934), 31 BTA 206, the taxpayer for a number of years had used the inventory basis of reporting its income from its cattle ranches. After some controversy with the Commissioner, the taxpayer's

liability for prior years was settled on an inventory basis. Without seeking permission from the Commissioner, the taxpayer filed its returns for 1929 and 1930 on the cash basis. The Commissioner determined deficiencies, holding that the return should have been made according to the inventory method and not on the cash basis, since the Commissioner had not granted permission for the change. The Board of Tax Appeals held that the taxpayer properly reported its income on the cash basis, since the inventory basis as used by the taxpayer did not clearly reflect its income. The Board said (at page 211)

> "We think the method urged by the respondent does not clearly reflect petitioner's income. It appears that the cash receipts and disbursements method as used by petitioner does correctly reflect its income. Therefore, in view of all the circumstances, we hold that the Commissioner's refusal to approve the cash method is an unreasonable and arbitrary exercise of his power not contemplated by the statute."

And in a case very much like this one, *R. G. Bent Co. v. Comm'r* (1932), 26 BTA 1369, the Board of Tax Appeals concluded that the taxpayer's income "could be accurately computed upon the completed contract basis and only estimated inaccurately upon the accrual basis." Hence it required the taxpayer to use the completed contract basis.

Similarly, it was held in *Walter Tillman Estate* (1928), 10 BTA 4, that where accounts were so kept that taxable income could be accurately computed on the accrual basis but could not be accurately determined on the installment basis, the accrual and not the installment basis must be used.

And while the cash method of accounting is generally acceptable (Int. Rev. Code Sec. 42; Regs. Sec. 19.41-2), the authorities setting forth the circumstances under which

that method does not clearly reflect income, and thus is unacceptable, are numerous. E.g. Regs. Sec. 19.41-2; *Herberger v. Comm'r* (9th Cir., 1952), 195 F.2d 293, cert. den. 344 U.S. 820; *Caldwell v. Comm'r* (2nd Cir., 1953), 202 F.2d 112.

The reason why the completed contract method of accounting is utilized and is generally accepted as clearly reflecting income in the case of construction contracts, while the accrual method may not, was stated by this Court in *Bent v. Comm'r.* (9th Cir., 1932), 56 F.2d 99, 102-103 as follows:

> "* * * But in either event the contract is a unit, and until the contract is completed and accepted, it cannot be definitely known what the profit may be or what loss may be suffered by the contractor. The books are full of instances where, by reason of defective work or unsuspected obstacles or changes in prices of labor and materials, contractors have suffered losses, notwithstanding the unit price basis and in the case of the contract based upon cost plus a fixed fee the work may be prolonged over a long period of time by reason of difficulties in the work, or the fee might be diminished or wholly lost because of inability to complete the contract. These observations, familiar to all, are made merely for the purpose of indicating that *under such contracts the income, that is the profit derived from a contract is not necessarily reflected by the payments made thereunder for a particular period,* whether such payments are upon a lump sum contract basis, or unit price basis, or cost plus a fixed fee basis." (Italics added.)

The factors noted by the court in the *Bent* case were of course, present here at the end of 1942. More importantly, however, if the taxpayers were required to close out this contract simply by deducting accrued costs from accrued income, the returns would reflect an unrealistic loss in 1942, and, on the other hand, would reflect an unrealistic income in 1943. It cannot be said that the accrual method as thus

applied to this case would "clearly reflect the income" for either 1942 or 1943.

b) ANY "ELECTION" BY THE TAXPAYER TO ADOPT THE ACCRUAL METHOD OF ACCOUNTING WAS AN INNOCENT MISTAKE, MADE UNDER AN ERRONEOUS ASSUMPTION, AND THE TAXPAYER SHOULD BE RELIEVED OF THAT "ELECTION".

The reasons why the taxpayers reported income from the Delta contract before it was completed are in the record and have previously been discussed herein. It was done because of the demand of the army officer renegotiating the Delta contract, and because of belief that the taxpayer was required to report income for tax purposes upon the same basis as it was reported for renegotiation purposes.

The doctrine of "election", as described in the *Tide Water Oil Co.* case, cited previously, is that "in order to be bound by his election a party must have made an election with knowledge of his rights upon which the other party properly relied."

There was, of course, no reliance by the defendant upon the mistake made here in the 1942 return. On the contrary, the plaintiffs have so far been denied the right to compute their tax liability in a correct manner. But more than that, the "election" which was made by the plaintiffs was made under a most serious misapprehension of their rights, if that election required (unbeknownst to them at the time) that they report a large loss from the contract in 1942 and an even larger income from the contract in 1943. In this light, this case is like *Meyer Est. et al. v. Comm'r.* (5th Cir., 1952), 200 F.2d 592. There it was held that an election to be taxed at ordinary income rates on the earned surplus of a liquidating corporation could be revoked when the election was made under a misapprehension as to the amount of the earned surplus. Section 112(b)(7) of the 1939 Code was an optional provision permitting the dissolution of a cor-

poration without tax to the shareholders except to the extent of the earned surplus of the corporation, which was taxed as ordinary income. The taxpayer relied upon figures prepared by his accountant showing that the earned surplus was about \$80,000, but on audit the Commissioner found that the correct surplus was more than \$1,000,000. The taxpayer attempted to withdraw and rescind his election. The Court of Appeals pointed out that there was no fraud or bad faith in making the election, and therefore held that the taxpayer was not bound by it, stating:

> "* * * To hold petitioner to the election under Section 112(b)(7) where Section 113(c) would have been clearly indicated but for the stipulated mistake of fact as to the large earned surplus figure would in effect convert a remedial statute enacted to aid taxpayers into a punitive statute reflecting a disproportionately harsh tax liability upon them. No such inequitable result is here warranted."

Similar cases include *George N. Klemyer* (1930), 20 BTA 934, where the taxpayer filed returns for four years on a fiscal year basis under a misconception of the law, and it was held that the taxpayer did not, under the circumstances, thereby elect to establish a fiscal year accounting period. See also *Estate of Cyrus H. K. Curtis* (1937), 36 BTA 899, which is similar.

In Pomeroy's Equity Jurisprudence, page 512 (3rd Edition) it is stated that:

> "* * * It follows that where an election has been made in ignorance or under a mistake as to the real condition and value of the properties, or under a mistake as to the real nature and extent of the party's own rights, such a mistake is regarded as one of fact, rather than of law; the election itself is not binding, and a court of equitable powers will permit it to be revoked, unless

the rights of third persons have intervened which would be interfered with by the revocation."

The above was cited by the Court in *McIntosh v. Wilkinson* (E.D. Wisc. 1929), 36 F.2d 807, determining that under the facts of that case, the filing of separate returns did not constitute a binding election.

Certainly in this case, any "election" to adopt an accrual method of accounting was an election made in ignorance of the taxpayers' rights, and a misapprehension of its consequences. If the taxpayer elected the accrual method for 1942 he should be relieved of that election and permitted, through the claims for refund and this action, the opportunity for a really fair choice. See *Morrow, Becker & Ewing, Inc. v. Comm'r.* (5th Cir., 1932), 57 F.2d 1, where the Court of Appeals said: "Taxes are assessed on income and not on honest mistakes of the taxpayer."

3. The grounds stated in the refund claims and the basis asserted in the complaint for refund, included the specification of improper accrual of gross receipts in the amount of $472,722.15. Thus, the Court should have permitted the correction of the error by correctly applying the accrual method.

In the opinion of the District Court (Tr. 106), the following language appears:

> "It does appear that some of the Delta contract income in fact did not accrue until 1943 and was improperly included in the 1942 return. To this extent the 1942 return was erroneous. But that error cannot be reached or corrected in this action. For plaintiffs in their refund claims and in the complaint herein sought refunds *solely on the ground that all of the Delta contract receipts had been erroneously reported as income in 1942 as a result of a mistaken application of the completed contract method of accounting.*" (Italics added.)

And in the Court's Conclusions of Law III (Tr. 111), it is stated:

"That portion of the income from the contract that actually accrued in 1943 cannot be refunded in this action because the grounds stated in the refund claims, and the basis asserted in the complaint for refund, *were solely that all of the receipts from the contract had been erroneously reported as income in 1942.*" (Italics added.)

Perhaps the District Court meant by this language that it would not even consider correction of the errors in the 1942 return, because the only error which it found (an improper application of the accrual method of accounting) was not specified in the refund claims or the complaint. Thus the District Court may not have reached the question of whether the error would be correctable by switching to the completed contract method of accounting (as is argued above) if the Court had found in the claim for refund a specification of the erroneous accrual of $472,722.15. It is respectfully submitted that if this was the reasoning of the Court, it is fallacious. If the way in which the error should be corrected is to report none of the gross receipts) in 1942 (using the completed contract method) does it not follow that "all of the receipts from the contract had been erroneously reported as income in 1942"? This is the ground upon which the District Court found that the claim and complaint were based. Accordingly, it is submitted that the asserted insufficiency in the claims for refund and the complaint is not material unless it be concluded that the error in the 1942 return is correctable, if at all, only by shifting the receipts improperly accrued from 1942 to 1943.

As an additional preliminary matter, it seems appropriate to note that defendant did not find that the refund claims and the complaint were based "solely on the grounds * * * of a mistaken application of the completed contract method of accounting" as the District Court concluded in its

opinion. On the contrary, counsel for the defendant made the following statement in open court (Tr. 136):

> "The essence of this thing [the claim for refund] and the essence of the complaint is that the returns as filed were on the accrual basis, that they made a mistake in filing them on the accrual basis, they should have been filed on a completed contract basis because the contract was completed in 1943."

Since the entire doctrine requiring a statement of the grounds of a claim for refund is designed to afford an opportunity for administrative adjustment without suit, and the defendant obviously understood that improper application of the accrual method was one of the grounds of the claim, this should end the matter. *Samara v. United States* (2nd Cir.), 129 F.2d 594.

Be that as it may, an examination of the refund claims and the complaint demonstrate that both the improper accrual of receipts and the improper application of the completed contract method were set forth as grounds for the refund.

Looking first to the claims for refund (as amended) which were all in the form of Exhibit No. 22 to the Stipulation of Facts (Tr. 97), we read the following (at Tr. 99):

> "The following reasons that this claim should be allowed are in accordance with the original claims which were timely filed:
>
> > "The *amended partnership returns* were filed to correct the erroneous returns which were filed for years 1942 and 1943. The *amended returns* as filed are consistent with the accounting procedure used by Daley Brothers during the year 1943 and prior. The *amended returns* are to correct the Delta, Utah, contract, which was completed in the year 1943 and erroneously included in income for the year 1942. . . ." (Italics added.)

This claim for refund is by its terms based in part upon the amended partnership returns. The law is clear that an amended return accompanied by a claim on the proper form is a proper way to set forth grounds for a claim for refund. I.T. 1450, I-2 CB 200; *Lebolt & Co. v. U. S.* (1929), 67 Court of Claims 422; *Standard Computing Scale Co. v. U. S.* (1931), 52 F(2d) 1018. (Under the present regulations, an amended return alone is sufficient, without the necessity of also submitting the claim on Form 843. Regs. § 301.6402-3.)

In order to determine the way in which the original 1942 return was erroneous, and the way in which the amended returns "correct the erroneous returns" you would naturally look to the original and amended returns and compare them. These returns are set forth on pages 86-90 of the Transcript.

Looking on the face of the original return for 1942 (Tr. 86) we see

"1. Gross receipts from business
or profession..$3,655,672.28."

The testimony was that this figure was the estimated full contract price (Tr. 166). Looking next at the face of the amended return for 1942 (Tr. 88), we find on the same line the following:

"1. Gross receipts from business or
profession...............(Advances only $3,180,536.97)."

It is readily seen that if there is added to the figure $3,180,-536.97 (shown in the amended return) the sum of $472,722.15 (the erroneous accruals), the result is $3,653,259.15 (which is the actual full contract price). Stip. of Facts, paragraph 8, Tr. 21. In other words, on the 1942 amended partnership return, constituting a part of the claim for refund, there was deducted from the gross receipts originally reported the amount of the improper accruals.

It should also be noted that on the amended return, in response to question No. 4, it is stated that the return was prepared on the accrual basis (Tr. 89). This is the same response that was given to this question on the original return (Tr. 87). Thus, the claim for refund specifically states, in the clearest possible manner, that one of the errors shown on the original 1942 return was that the gross receipts from business or profession had been overstated by improper accruals in a specified amount. To be sure, the amended 1942 return also states that such gross receipts should have been reported only as advances, but that is the *second* ground upon which it is asserted that the original 1942 return was erroneous.

The complaint in this case also sets forth the grounds which the District Court found to be lacking. Thus, in paragraph VI, at Tr. 9, the complaint sets forth specifically the provisions of the Delta contract providing for payments on estimates prepared by the contracting officer, and providing for a 10% holdback. *These are the provisions of the contract upon which the plaintiffs relied* in arguing in the District Court that the sum of $472,722.15 had not been accrued by December 31, 1942.

In paragraph VII of the complaint it is alleged that "said moneys received under the contract for the Delta Venture was not income for any year until the said contract was completed as provided for in the contract, and accepted by the United States Government."

This is an assertion that neither the whole nor any portion of the moneys received (the gross receipts) of the Delta contract was earned until the contract was completed and accepted. The final progress payments and payment of the "holdbacks" (which were the amounts erroneously accrued) were both to be made only when the contract was completed

and accepted by the United States Government. See the terms of the contract set forth in the complaint at Tr. 9.

In paragraph IX of the complaint (Tr. 11) it is stated that "said income tax return was erroneously made and reported under the mistaken theory that the *income* was *earned* in the calendar year 1942. This *income* was then inadvertently reported by the plaintiffs as *income* as to their respective shares by the plaintiffs herein on their individual returns for said year." (Italics added.)

The term "income" as used in paragraph IX of the complaint should be distinguished from the term "moneys" used in paragraph VII of the complaint. As can be quickly seen from an examination of the face of the return (Tr. 86), gross receipts is not "income"; the cost of goods sold must be deducted before reaching an item of "income". Regs. § 19.22(a)-5 ("* * * 'gross income' means the total sales, less the cost of goods sold * * *"); *Uptegrove Lumber Co. v. Comm'r.* (3rd Cir., 1953), 204 F.(2d) 570. Moreover, the "income" which the complaint alleges was inadvertently reported by the plaintiffs on their respective individual returns was obviously the net income shown on the original partnership return, viz., $206,250.44. See Schedule J of the original return (Tr. 87). Gross receipts of a partnership do not find their way to the original return. And the term "earned," used in paragraph IX, is an accrual concept, not a completed contract concept. See the language quoted from the *Fort Pitt Bridge Works* case, supra, pg. 9. The point is that paragraph IX of the complaint says quite clearly that the income tax return was erroneous in that income was reported in 1942 when in fact, because of improper accruals, no such income existed in 1942.

It appears that the District Court may have confused the "grounds" stated in the refund claims and the complaint

with the "relief" requested. Appellants concede that they have taken the position that the way in which the error in the 1942 return should be corrected is to shift all items of income and deduction to 1942 when the contract was completed. In other words, the completed contract method should be correctly applied. Thus, in the amended returns submitted with the claims for refund, the 1942 return showed the income and deductions accrued through December 31, 1942, as in suspension, and reported no net income or loss (Tr. 88). And the amended return for 1943, when the contract was completed, reported the full contract price and all expenses and the net profit therefrom (Tr. 90, 91). This is the proper way of reporting income for tax purposes on the completed contract method of accounting. *Fort Pitt Bridge Works v. Comm'r.* (supra, p. 9).

Similarly, the amount of refunds requested in the complaint (Tr. 13) were based on the amounts requested in the claims for refund, which, as already stated, were computed on the completed contract method.

But simply because a taxpayer asks for a greater refund than that to which he is entitled is not sufficient grounds upon which to deny him the refund to which he is entitled. See Rule 54(c) of the Federal Rules of Civil Procedure:

> "Every final judgment shall grant the relief to which the party in whose favor it is rendered is entitled, even if the party has not demanded such relief in his pleadings."

See also *Agarano v. U. S.* (D.C. Hawaii, 1953), 110 F. Supp. 609.

Thus, if this court determines that the plaintiffs adopted the accrual method of accounting, and that they are not entitled to correct the error in the 1942 return by using the completed contract method, it is respectfully submitted

that they are nevertheless entitled to a reversal with instructions that computations be made on the basis of the accrual method of accounting, pursuant to the Supplemental Stipulation of the parties (Tr. 101).

If this Court considers that the claim for refund may not have given adequate notice of the contentions of plaintiffs, then it is requested that the case be remanded to the District Court for further proceedings. Plaintiffs are prepared to submit documentary and other evidence which will prove that both before and after filing the complaint herein, accountants and counsel for plaintiffs met frequently with representatives of defendant, and submitted evidence and legal memorandum to them, in an effort to convince them that even on the accrual method of accounting no income would have been reported on the 1942 return. Representatives for the defendant consistently took the position that the 1942 return was substantially correct on the accrual method of accounting, and never objected to the form of the claim for refund in this or any other respect. The defendant, through its representatives, consistently maintained the same position which the courts recently held to be erroneous in the *Dally* and *Harmon* cases (*supra*, pg. 10). Based upon the defendant's brief in the District Court, it does not appear that they have *yet* conceded that the 1942 return was in error on the accrual method of accounting. There thus was no surprise, no failure of opportunity to dispose of this case on the administrative level. On the contrary, by the failure of the defendant to raise any objection to the form of the claim for refund in the Answer (Tr. 13), or at the trial, the appellants were surprised and aggrieved, and are entitled to a remand for the purpose of proving waiver of any defect which existed. (As to waiver of defects in claims for refund see *Angelus Milling Co. v. Comm'r* (1945), 325 U. S. 293, 65 S. Ct. 1162; *Union Trust Co. of Pittsburgh et al. v.*

McCaughn (D.C. Penn., 1927), 24 F.2d 459; *Foster Box Board Co. v. Clarke,* 7 F. Supp. 682, aff'd (2nd Cir., 1937), 90 F.2d 1008; *Lehigh & Wilkes-Barre Coal Co. v. U. S.* (D.C. Penn., 1930), 38 F.2d 637. As to the requirement that an objection to the form of the claim for refund be pleaded specifically in the answer, see *Howbert v. Penrose* (10th Cir., 1930), 38 F.2d 577 and *Northwestern Nat. Bk. & Trust Co. of Minn. v. U. S.* (D.C. Minn., 1942), 46 F. Supp. 390, aff'd 137 F.2d 761.

CONCLUSION

After many years of following a consistent accounting practice of reporting income on the completed contract method, Appellants were asked by a renegotiation officer and an agent of the defendant herein, in connection with the first renegotiation which they had undergone, to treat a large contract which was almost completed as if it had been completed at the end of 1942. Appellants complied against their wishes and without any anticipation of gain therefrom. On the contrary, in closing out the books on the contract prior to its completion and making out their tax return accordingly, the appellants made errors which resulted in large increases in the income taxes which they paid. Under any standards of justice and equity, appellants should be entitled to recompute their liability for income taxes on the basis of standards applicable to all other taxpayers.

The technical merits of the appellants' case are equally strong. Despite the fact that the books of account were closed before the Delta contract was completed, the accounting "method" employed was the completed contract method, and the Conclusion of Law of the District Court to the contrary is clear error. Accordingly, appellants are entitled to recompute their taxes by correctly applying the completed contract method. Even if by closing the Delta con-

tract before its completion the taxpayers converted the completed contract method into some other method of accounting, they nevertheless are entitled to recompute their liability by using the completed contract method, since that is the only method which, under the circumstances of this case, would "clearly reflect the income."

In any event the District Court was in error in failing to allow the appellants to correct the 1942 return by shifting the erroneous accruals from 1942 to 1943. These errors were clearly proven on the basis of stipulated facts, and to the satisfaction of the District Court. The claims for refund and complaint set forth the existence of these errors as one of the grounds for refund. The fact that the plaintiffs also alleged other errors, and asked for a greater refund than that to which the District Court found they were entitled, is not a sufficient basis upon which to deny the plaintiffs any recovery whatever.

The District Court should be reversed, with instructions to enter judgment for appellants, based upon computations made pursuant to the Supplemental Stipulation of the parties (Tr. 101) and in accordance with the opinion of this Court.

Dated: November 29, 1956.

Respectfully submitted,

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(Appendix Follows)

Appendix

RENEGOTIATION ACT

Section 403(c)(5) of the Sixth Supplemental National Defense Appropriation Act, 1942, Pub. L. No. 528, 77th Cong. 2d Sess., April 28, 1942, as amended by Pub. L. No. 753, 77th Cong., 2d Sess., October 21, 1942:

> "(5) Any contractor or subcontractor who holds contracts or subcontracts, to which the provisions of this section are applicable, may file with the Secretaries of all the Departments concerned statements of actual costs of production and such other financial statements for any prior fiscal year or years of such contractor or subcontractor, in such form and detail, as the Secretaries shall prescribe by joint regulation. Within one year after the filing of such statements, or within such shorter period as may be prescribed by such joint regulation, the Secretary of a Department may give the contractor or subcontractor written notice, in form and manner to be prescribed in such joint regulation, that the Secretary is of the opinion that the profits realized from some or all of such contracts or subcontracts may be excessive, and fixing a date and place for an initial conference to be held within sixty days thereafter. If such notice is not given and renegotiation commenced by the Secretary within such sixty days the contractor or subcontractor shall not thereafter be required to renegotiate to eliminate excessive profits realized from any such contract or subcontract during such fiscal year or years and any liabilities of the contractor or subcontractor for excessive profits realized during such period shall be thereby discharged."

RENEGOTIATION PROCEDURES

Excerpt from "Introduction to the Renegotiation Regulations" (Commerce Clearing House War Law Service, Government Contracts, page 2905) (1944):

"5. *Development of Procedure for Renegotiation.*

"The scope of the statute molded its administration. Under the Act, renegotiation applied to all contracts and subcontracts (with specified exceptions), and could be required after the contract had been completed. These provisions seemed to render contractors liable, until three years after the war, to refund such part of any profits earned by them on their war contracts or subcontracts as the procuring agency might require. Since the prices of all contracts and subcontracts subject to the statute obviously could not, within any reasonable period, be examined and renegotiated individually, some other means had to be developed for disposing of this potential liability.

"These circumstances led to the adoption of the method of overall renegotiation. This procedure permitted the contractor's profits on his entire war business to be examined for a specific fiscal period in order to reach an agreement for eliminating excessive profits on such contracts as a group and for that period. Besides reducing the administrative burden, this procedure had several other advantages. The consideration of all contracts and subcontracts as a group reduces cost accounting and allocations of cost to a minimum and saves time for both contractors and the Government, and the use of the fiscal period for renegotiation facilitated the use of the regular financial and accounting material of contractors and avoided the preparation of such data on an entirely different basis. In addition, this method allowed the contractors to offset their losses on one or more war contracts against their profits from other war contracts during the same period.

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"In October, 1942, Congress adopted certain amendments proposed by the Departments primarily to confirm the procedures developed in practical administration of the statute."

RENEGOTIATION REGULATIONS

Renegotiation Regulations of the War Contracts Price Adjustment Board, Title 32, Code of Federal Regulations, Parts 1601-1608 (Supplement 1944):*

301.1 *Statutory Provisions.* Subsection (c) (1) of the Renegotiation Act of 1943 provides in part:

> "* * * The Board shall exercise its powers with respect to the aggregate of the amounts received or accrued during the fiscal year (or such other period as may be fixed by mutual agreement) by a contractor or subcontractor under contracts with the Departments and subcontracts, and not separately with respect to amounts received or accrued under separate contracts with the Departments or subcontracts, except that the Board may exercise such powers separately with respect to amounts received or accrued by the contractor or subcontractor under any one or more separate contracts with the Departments or subcontracts at the request of the contractor or subcontractor."

301.2 *Use of Fiscal Year Basis—In General.*

(1) This provision requires the War Contracts Board to renegotiate on a fiscal year basis (or such other period as may be fixed by mutual agreement). It also requires that renegotiation be conducted upon an over-all basis unless the contractor or subcontractor requests, and the War Contracts Board agrees, that such renegotiation be conducted

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*While Renegotiation Regulations were not promulgated until after renegotiation of the Delta contract, they are believed to represent, in substance, the procedures used theretofore. See "Renegotiation Procedures", Appendix pg. 2.

with respect to his contracts and subcontracts separately or as two or more groups.

(2) Generally, renegotiation will be conducted on the basis of the amounts received or accrued by a contractor from his renegotiable contracts and subcontracts for a past fiscal year. Under this method excessive profits are determined by examining the contractor's financial position and the profits from such contracts and subcontracts taken as a whole for a particular fiscal year rather than by separate analysis of each contract or subcontract. This avoids problems of allocation of costs and profits, as between each contract and subcontract, allows the contractor to offset the results of one contract against another and simplifies administration.

301.3 *Renegotiation on a Completed Contract Fiscal Year Basis—Contruction Contracts.*

(1) Contractors having construction contracts or subcontracts may have used a completed contract method of accounting for Federal income tax purposes with respect to some or all of such contracts or subcontracts. With respect to the contracts and subcontracts for which the completed contract method of accounting was used, such method of accounting will be followed for all purposes of the Renegotiation Act and the regulations and interpretations promulgated thereunder. In the case of any contract or subcontract for which the completed contract method of accounting is followed, all amounts received or accrued thereunder and all costs paid or incurred with respect thereto will be treated as having been received or accrued or paid or incurred within the fiscal year in which the contract or subcontract was completed.

(2) A contractor who has used the completed contract method of accounting for Federal income tax purposes with

respect to some of his construction contracts and subcontracts and who desires the use of such method with respect to his other construction contracts and subcontracts, or a contractor who has not used such method of accounting for Federal income tax purposes with respect to any of his contracts or subcontracts, may, nevertheless, request that the completed contract method of accounting be used for the purposes of renegotiation with respect to all of his construction contracts and subcontracts completed or terminated within the fiscal year. If such request is approved by the Department to which the contractor has been assigned, the contractor will be deemed to have adopted the completed contract method of accounting with respect to such contracts and subcontracts, for the purposes of renegotiation. The form to be used in making such a request is set forth in paragraph 723. The Department concerned will not approve such request unless (a) it appears that the effect of granting such a request would not be inconsistent with the general purposes of the Act, (b) the contractor agrees to all the terms and conditions stated in paragraph 723, and (c) the request relates to all construction contracts and subcontracts completed or terminated within the fiscal year being renegotiated. If such request is approved, the Renegotiation Act, and the regulations and interpretations promulgated thereunder other than those dealing with the allowance of tax credits, will be applied in all respects to such construction contracts and subcontracts and the profits derived therefrom as though, with respect to them, the contractor had used the completed contract basis of accounting in keeping his books and in making his Federal income tax return. The $500,000 fiscal-year exemption provided in subsection (c) (6) of the Renegotiation Act, the interpretation relating to the $500,000 "floor" as set forth in paragraph

348.3, as well as all other provisions of the 1943 Act, will be applied in like manner. The contracts or subcontracts renegotiated on the completed contract basis are subject to such separate treatment as may be required because of the different types of contracts involved (such as fixed-price, cost-plus-fixed-fee, price-minus contracts, contracts subject to contractual or statutory fixed profit limitations and contracts providing for redetermination or revision of the contract price during the life of the contracts). In this connection, attention is directed to paragraphs 306 and 307.

301.6 *Contracts to Be Included in a Completed Contract Renegotiation.* Subject to the provisions of subparagraph 301.3 (2) with respect to separate treatment of different types of contracts, contracts and subcontracts to be renegotiated on a completed contract basis will be renegotiated as a group when completed within a given fiscal year, but contracts completed in one fiscal year may not be grouped with contracts completed in a different fiscal year.